



# KBC Flash

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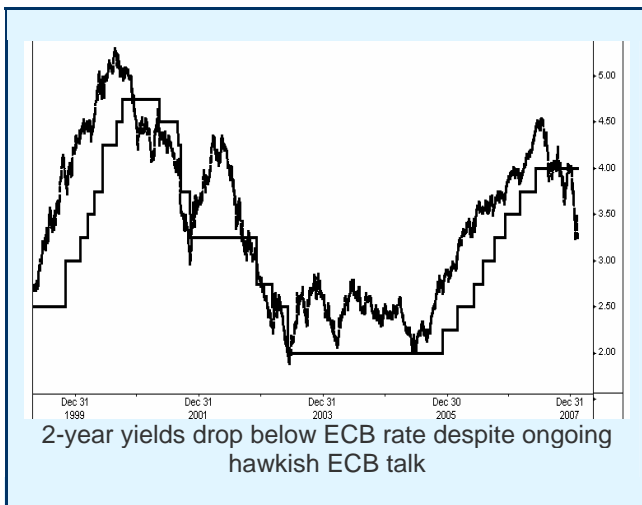
## Another difficult balancing act for the ECB

- ECB still pressured between rising inflation and weaker growth, but...
- ...Inflation peak in February and weak Q4 GDP growth data may increase room for manoeuvre from March meeting onwards
- We still see two rate cuts by 25 bps in March and June

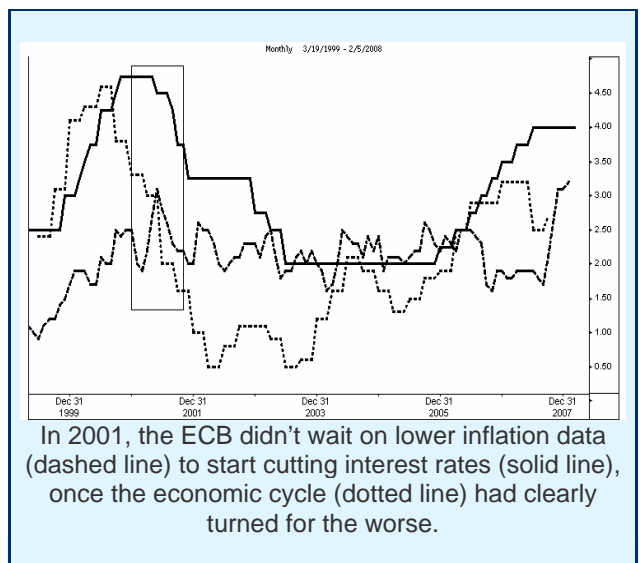
At the February policy meeting, the ECB governing council is widely expected to leave rates unchanged at 4% for the 8<sup>th</sup> consecutive month. Market expectations towards an easing in policy have increased dramatically since the previous meeting however and now discount almost three rate cuts for 2008. The main question for this meeting is whether the ECB will soften its hawkish language and eventually drop its tightening bias.

months. In addition, falling consumer and services confidence and poor euro zone retail sales suggest that no substantial pickup in domestic demand should be expected. As such, economic growth is expected to slow significantly from Q4 on and to fall below trend, which should ease current inflation concerns at the ECB.

In this context, it's interesting to note that the composite PMI of the manufacturing and services sector has now fallen to levels (51.8) slightly below those prevailing when the ECB started to cut rates in May 2001 (April figure was 52.0). At that time, the ECB was confronted with a similar problem of conflicting developments, whereby economic growth had peaked, but inflation was still rising mainly due to higher food and oil prices. It may be instructive that above target inflation did not prevent the ECB from cutting interest rates. Indeed in May 2001, the ECB cut interest rates by 25 basis points from 4.75% to 4.50%, even though the inflation rate was moving up and hit 3.1% Y/Y in May.



Until now, the ECB has continued to warn that higher inflation is a far more pressing concern than a slowing in economic activity and stressed that it 'remained prepared to act pre-emptively so that second-round effects and upside risks to price stability over the medium term do not materialise'. However, recent eco data indicate that the ECB scenario of growth 'broadly in line with potential' is starting to look overly optimistic.



The recession fears in the US, underscored by yesterday's drop in the ISM non-manufacturing, together with evidence of a marked deterioration in UK domestic demand amplified by the strength in the euro will translate into a notably poorer external backdrop for euro zone activity in the coming

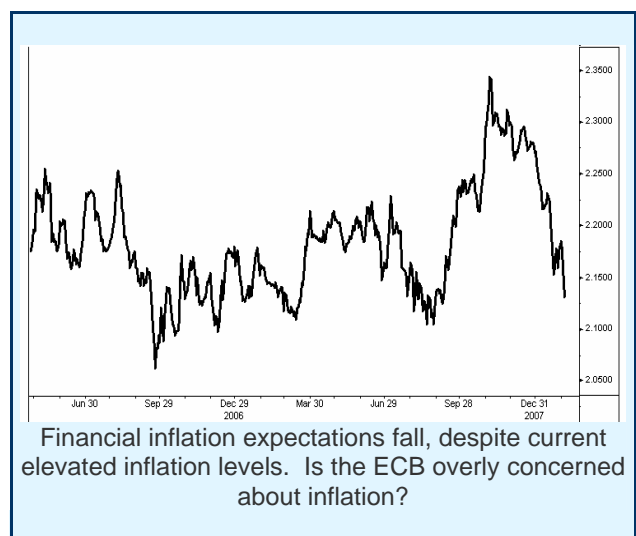
**One important difference this time compared to 2001 is related to the strong underlying rate of money and credit growth.** In the period from January to March 2001, the three-month average of the annual growth rate in M3 was 4.8%, which is substantially lower than the current rate of 12.1%. The stronger growth rate is seen by some at the ECB as signalling upside risks to price stability at medium to longer-term horizons now compared to 2001. **Hence, the different rate of money growth supports a more cautious approach of the ECB governing council with regard to interest rate cuts this time.** However since 2001, the monetary pillar has lost some of its importance within the ECB monetary policy framework and in its latest statement Trichet stated that *'the annual growth rate is likely to have been influenced by a number of temporary factors, such as the flattening of the yield curve, the financial market turmoil and specific transactions associated with the restructuring of certain banking groups'*. As such, we wouldn't exaggerate the importance of the current strong pace of money growth with regard to future rate decisions.

The same conclusion can also be drawn from the vigorous growth in loans to the domestic private sector, which grew at an annual rate of 11.1% in December compared 8.4% in May 2001. **Current vigorous credit growth is mainly the result of strong loan growth to non-financial corporations (14.4%), while loans to households (6.2%) have already slowed to its lowest pace since September 2003.** Previous credit cycles however indicate that growth in household loans tend to lead growth in corporate loans by around four quarters on average (ECB monthly bulletin of June 2007). Moreover, the peaks and troughs have typically been higher and deeper for corporate loans, which suggests that a significant slowing in demand for corporate loans is underway. The January ECB bank lending survey supports this view, as it points a significant easing in demand as well as a tightening in credit conditions.

**Ahead of Thursday's ECB meeting, we hold on to our longstanding view of two 25 basis points rate cuts in March and June of this year, but fully appreciate that the timing of the first rate cut could be a bit later.**

In all probability a March rate cut would require a further significant deterioration in the outlook for activity and/or greater pressures in financial markets. While the ECB would be anxious not to be seen to respond to short term developments, other factors are moving in a direction that will create leeway for an early move. By the time of the March meeting, the ECB governing council will know the Q4 GDP growth data and will have received an update of the ECB staff projections for growth and inflation. Recent ECB comments have already pointed towards a downward revision of the growth projections, but left the implications for

the inflation outlook mainly open. Weaker growth should however also result in a lower inflation profile and may hence project inflation to fall substantially below the 2% in 2009 (currently seen at 1.8% Y/Y). In addition, according to the ECB calculations, favourable base effects from both energy and non-energy prices are expected to make substantial downward contributions to inflation developments from March onwards. This implies that the annual inflation rate will probably peak in February and will start to decline gradually afterwards, which will increase the room for manoeuvre. Moreover compared to a few months ago, financial inflation expectations are also much less threatening. Since their peak in June at 2.35%, inflation expectations derived from French inflation linked bonds have fallen by around 20 bps to below 2.15% currently and are again in the range seen over the previous years. This suggests that the ECB fears that overall longer-term inflation expectations may rise might be overdone, even while the price balances in several surveys remain elevated.



**Hence, going into this week's ECB press conference, we hold on to our positive view for bonds, but wouldn't add to current long positions, as the ECB may still be reluctant to soften its hawkish stance significantly at this meeting and given current market expectations, which discount already three ECB rate cuts this year of which almost two are priced in by the June meeting. A buy on dips approach towards the 104.50 level in the Schatz is therefore preferred.**

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